INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statute and regulations involved	2
Statement	2
Argument	4
Conclusion	9
Appendix	10

CITATIONS

Cases:

Breuner, John, Co. v. *Commissioner*, 179 F. 2d 685, certiorari denied May 29, 1950	4, 6, 7, 8
Busch's Kredit Jewelry Co. v. *Commissioner*, 179 F. 2d 298, certiorari denied May 29, 1950	4, 7, 8
Commissioner v. *South Texas Co.*, 333 U. S. 496	6, 7, 8
Commissioner v. *Wheeler*, 324 U. S. 542	6
Hadley Furniture Co. v. *United States*, 87 F. Supp. 590	6
Kimbrell's Home Furnish., Inc. v. *Commissioner*, 159 F. 2d 608	7, 8
White Bros. Co. v. *Commissioner*, 180 F. 2d 451	6

Statute:

Internal Revenue Code:

Sec. 44 (26 U.S.C. 1946 ed., Sec. 44)	5, 10
Sec. 115 (26 U.S.C. 1946 ed., Sec. 115)	7, 10
Sec. 718 (26 U.S.C. 1946 ed., Sec. 718)	3, 5, 12
Sec. 736 (26 U.S.C. 1946 ed., Sec. 736)	5, 6, 7, 8, 13

Miscellaneous:

Treasury Regulations 109, Sec. 30.736(a)-2	6, 15

In the Supreme Court of the United States

OCTOBER TERM, 1950

No. 91

MAY, STERN AND COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court (R. 8a-13a) and its supplemental memorandum findings of fact and opinion (R. 19a-26a) are not reported. The opinion of the Court of Appeals for the Third Circuit (R. 37-49) is reported at 181 F. 2d 407.

JURISDICTION

The judgment of the Court of Appeals for the Third Circuit was entered on April 10, 1950. (R. 49-50.) The petition for a writ of certiorari was filed on May 26, 1950. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTION PRESENTED

Whether in computing its excess profits tax credit, taxpayer, which filed its income tax returns on the installment basis under Section 44(a) of the Internal Revenue Code, and which elected under Section 736(a) to compute its excess profits net income on the accrual basis, may include its uncollected installment profits as of the beginning of the taxable year in its "accumulated earnings and profits" within the meaning of Section 718(a)(4) of the Internal Revenue Code for the purpose of computing the excess profits tax credit on the invested capital basis, notwithstanding that the uncollected profits were from pre-1940 sales and hence had been subjected neither to income nor excess profits taxes.

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of the statute and relevant Regulations are set forth in the Appendix, *infra*, pp. 10-17.

STATEMENT

The facts relevant to the issue raised by the petition for certiorari were found in the Tax Court's first opinion (R. 9a-11a) and were restated and additional facts found in its supplemental memorandum findings of fact. (R. 20a-22a.) They may be summarized as follows:

The taxpayer has its principal place of business in Pittsburgh. It is engaged in the business of buying and selling home furnishings to the retail trade, and sells merchandise under install-

ment sales contracts. It keeps its books of account and reports its income on the basis of a fiscal year ending January 31, and, in general, under the accrual method of accounting. It computes its income from installment sales contracts, however, on the installment basis for federal income tax purposes under Section 44 (a) of the Internal Revenue Code. (R. 20a-21a.)

Taxpayer's first taxable year under the Excess Profits Tax Act of 1940, began February 1, 1940, and ended January 31, 1941. In 1943, it elected under Section 736 (a) of the Code to compute income from its installment sales on the accrual basis for the purpose of the excess profits tax. Accordingly, it filed an amended corporation excess profits tax return for the fiscal year ended January 31, 1941, in which it reported, in its excess profits net income, income from that fiscal year's installment sales in the net amount of $363,896.09, as determined on the accrual basis. An amended corporation income tax return for the same year reported net income of $83,331.91. In that return, income from installment sales was reported on the installment basis permitted under Section 44 (a) of the Code. (R. 21a.)

In its amended excess profits tax return for the year ended January 31, 1941, taxpayer reported accumulated earnings and profits of $3,919,768.94.[1]

---

[1] Taxpayer computed its excess profits credit on the invested capital basis; under Section 718 of the Code one element of invested capital is "accumulated earnings and profits."

In this amount was an item of $1,297,745.79,[2] which represented unrealized earnings and profits on installment sales as of the beginning of that taxable year (February 1, 1940). These unrealized profits constituted that portion of taxpayer's accounts receivable representing uncollected gross profits on installment sales made prior to February 1, 1940. (R. 21a-22a.) They had not been reported as taxable income for either excess profits tax or income tax purposes (R. 21a-22a, 45).

The Commissioner excluded from taxpayer's equity invested capital as of February 1, 1940, the above amount of $1,297,745.79. This determination resulted in a reduction of the eight percent excess profits tax credit to $207,097.87, and led to a deficiency in excess profits tax (after other adjustments) in the amount of $89,774.93. (R. 22a.)

The Tax Court approved the Commissioner's determination (R. 22a-27a) and the Court of Appeals affirmed (R. 49-50).

ARGUMENT

1. The narrow question presented by this case lacks importance in itself, and the denial on May 29, 1950, of the Government's broader petitions for certiorari in *Commissioner* v. *Busch's Kredit Jewelry Co.*, 179 F. 2d 298 (C. A. 2), (No. 804, October Term, 1949), and *Commissioner* v. *John Breu-*

[2] The Tax Court opinion (R. 21a) sometimes refers to this item as being in the amount of $1,294,745.79 and (R. 22a) sometimes as being $1,297,745.79. The stipulated amount (R. 7a) must be taken as correct.

ner Co., 179 F. 2d 685 (C. A. 9), (No. 805, October Term, 1949), suggests that the present petition should likewise be denied. Those cases dealt with the related but different, and more important, issue of whether an installment-basis taxpayer under Section 44(a) of the Internal Revenue Code (*infra*, p. 10)—which had elected under Code Section 736(a) (*infra*, pp. 13-15) to report excess profits income on the accrual basis—could, as a result of the Section 736(a) election, include in earnings and profits under Section 718(a)(4) (*infra*, pp. 12-13) uncollected installment profits which had not been recognized for income tax purposes but because the sales had been made in excess profits tax years (*i. e.*, post-1939) had been recognized for excess profits tax purposes. The issue of those cases involved all of the excess profits tax years, and not merely pre-1940 earnings and profits, as here; a large number of pending cases were affected by the rulings sought to be reviewed. In contrast, the present case concerns only the narrower issue of the right of a taxpayer, which has made the Section 736(a) election, to include in earnings and profits uncollected installment profits resulting from sales made in pre-excess profits tax years (*i. e.*, pre-1940), and hence not realized or recognized for either income or excess profits tax purposes. This issue usually would affect only the earliest of the excess profits tax years, and it is doubtful if any

substantial number of other cases presenting the issue will arise.

2. Moreover, the decision below is in any event correct, reaches a result specifically directed by the Treasury Regulations, and presents no conflict. Both courts below held that an installment-basis taxpayer, electing under Section 736(a), may not include in earnings and profits uncollected installment profits attributable to pre-1940 sales, and accordingly not realized or recognized, at the time of the return, for either income or excess profits tax purposes. This is exactly the conclusion reached by two other Courts of Appeals (*John Breuner Co.* v. *Commissioner,* 179 F. 2d 685 (C. A. 9), certiorari denied on the Commissioner's petition on the other phases of the case, May 29, 1950 (No. 805, October Term, 1949; *White Bros. Co.* v. *Commissioner,* 180 F. 2d 451 (C. A. 5)).[3] It is also the result expressly required by the Regulations (Section 30.736(a)-2, Treasury Regulations 109 (Appendix, *infra,* p. 17)), and is in accord with the decision of this Court in *Commissioner* v. *South Texas Co.,* 333 U. S. 496. See also *Commissioner* v. *Wheeler,* 324 U. S. 542. There are no decisions to the contrary.

There is, thus, neither a conflict which would warrant the granting of the petition, nor a question of the correctness of the decision below under any

[3] The same result was also reached in *Hadley Furniture Co.* v. *United States,* 87 F. Supp. 590 (D. Mass.).

of the theories advanced by the lower courts as to the effect of Section 736(a):

(a) In the petition for certiorari in *Commissioner* v. *Busch's Kredit Jewelry Co., supra,* the Commissioner asserted (pp. 9, 11, 14) that the views expressed by the court below herein were inconsistent with those declared by the Second and other circuits reaching the result of that case.[4] That was because the court below seemed to interpret the impact of Section 736(a) on post-1939 accumulated earnings and profits, and to read its legislative materials, quite differently from the other courts. In addition, the Third Circuit's suggestion that Section 115 (l) (*infra,* p. 11), as construed by this Court (*Commissioner* v. *South Texas Co.,* 333 U. S. 496), requires that before an amount can be included in earnings and profits it must have been recognized for income tax purposes (R. 45-48), would, if logically applied to the *Busch's* issue, require a conclusion opposite to that reached by the Second, Fourth, and Ninth Circuits. But the converse is not true. Contrary to the implication of taxpayer's petition (pp. 8-12), the reasoning of the courts in *Kimbrell's, Busch's,* and *Breuner,* would not require a different conclusion on the issue of the present case. The same result is compelled whether one follows the reasoning of those cases, on the one

[4] *Kimbrell's Home Furnish., Inc.* v. *Commissioner,* 159 F. 2d 608 (C. A. 4); *John Breuner Co.* v. *Commissioner,* 179 F. 2d 685 (C. A. 9).

hand, or of the Third Circuit in the opinion below, on the other. Under the rationale of *Kimbrell's, Busch's* and *Breuner,* the critical question in determining what is to be included in earnings and profits is whether the amount sought to be included has been realized and recognized for excess profits tax purposes. Since Section 736(a) expressly provides that profits from sales in pre-excess profits tax years (*i.e.,* pre-1940) are not to be accrued for purposes of the excess profits tax (*infra,* p. 14), it is not possible to say that the uncollected profits in this case were either realized or recognized for excess profits tax purposes.[5] The consistency of the result below with the rationale of *Kimbrell's* and *Busch's* is illustrated by the fact that, in *John Breuner Co.* v. *Commissioner, supra,* the Court of Appeals for the Ninth Circuit, relying on *Busch's* and *Kimbrell's,* reached the result of those cases on the post-1939 earnings and profits, but on the issue of this case held with the Commissioner.[6]

(b) Nor is there any merit in the assertion (Pet. 12-16) that the decision below is contrary to the decision of this Court in *Commissioner* v. *South Texas Co.,* 333 U. S. 496. On the contrary, the court's decision turns (R. 46-48) on this Court's interpretation of Section 115(1) in *South Texas* (R. 45-48).

---

[5] It is also, of course, true that they had not been realized or recognized for income tax purposes. R. 21a-22a, 45; *supra,* p. 4.

[6] The taxpayer did not seek certiorari in *Breuner.*

CONCLUSION

The decision below is correct. There is no conflict of decisions. The petition should be denied.

Respectfully submitted,

PHILIP B. PERLMAN,
Solicitor General.
THERON LAMAR CAUDLE,
Assistant Attorney General.
ELLIS N. SLACK,
LEE A. JACKSON,
IRVING I. AXELRAD,
Special Assistants to the Attorney General.

JUNE 1950.

APPENDIX

Internal Revenue Code:

SEC. 44. INSTALLMENT BASIS.

(a) *Dealers in Personal Property.*—Under regulations prescribed by the Commissioner with the approval of the Secretary, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when payment is completed, bears to the total contract price.

* * * * *

(26 U. S. C. 1946 ed., Sec. 44.)

SEC. 115 [as amended by Section 501 (a) of the Second Revenue Act of 1940, c. 757, 54 Stat. 974, 1004, and as amended by Section 146 (a) of the Revenue Act of 1942, c. 619, 56 Stat. 798, 841]. DISTRIBUTIONS BY CORPORATIONS.

* * * * *

(l) *Effect on Earnings and Profits of Gain or Loss and of Receipt of Tax-Free Distributions.*—The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

(1) for the purpose of the computation of earnings and profits of the corporation, shall

be determined, except as provided in paragraph (2), by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but

(2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. Where in determining the adjusted basis used in computing such realized gain or loss the adjustment to the basis differs from the adjustment proper for the purpose of determining earnings or profits, then the latter adjustment shall be used in determining the increase or decrease above provided. For the purposes of this subsection, a loss with respect to which a deduction is disallowed under section 118, or a corresponding provision of a prior income-tax law, shall not be deemed to be recognized. Where a corpora-

tion receives (after February 28, 1913) a distribution from a second corporation which (under the law applicable to the year in which the distribution was made) was not a taxable dividend to the shareholders of the second corporation, the amount of such distribution shall not increase the earnings and profits of the first corporation in the following cases:

(1) No such increase shall be made in respect of the part of such distribution which (under such law) is directly applied in reduction of the basis of the stock in respect of which the distribution was made.

(2) No such increase shall be made if (under such law) the distribution causes the basis of the stock in respect of which the distribution was made to be allocated between such stock and the property received.

* * * * *

(26 U. S. C. 1946 ed., Sec. 115.)

CHAPTER 2—ADDITIONAL INCOME TAXES

* * * * *

SUBCHAPTER E—EXCESS PROFITS TAX

* * * * *

SEC. 718 [As added by Section 201, Second Revenue Act of 1940, *supra*, and amended by Section 203 of the Revenue Act of 1941, 55 Stat. 687]. EQUITY INVESTED CAPITAL.

(a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and

shall be the sum of the following amounts, reduced as provided in subsection (b)—

* * * * *

(4) *Earnings and profits at beginning of year.*—The accumulated earnings and profits as of the beginning of such taxable year;

* * * * *

(26 U. S. C. 1946 ed., Sec. 718.)

SEC. 736 [As added by Section 222 (d) of the Revenue Act of 1942, *supra*]. RELIEF FOR INSTALLMENT BASIS TAXPAYERS AND TAXPAYERS WITH INCOME FROM LONG-TERM CONTRACTS.

(a) *Election to Accrue Income.*—In the case of any taxpayer computing income from installment sales under the method provided by section 44 (a), if such taxpayer establishes, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, that the average volume of credit extended to purchasers on the installment plan in the four taxable years preceding the first taxable year beginning after December 31, 1941, was more than 125 per centum of the volume of such credit extended to such purchasers in the taxable year, or the average outstanding installment accounts receivable at the end of each of the four taxable years preceding the first taxable year beginning after December 31, 1941, was more than 125 per centum of the amount of such accounts receivable at the end of the taxable year, or if the taxpayer was not in existence for four

previous taxable years, the taxable years during which the taxpayer was in existence, in either case including only such years for which the income was computed under the method provided in section 44 (a), it may elect, in its return for the taxable year, for the purposes of the tax imposed by this subchapter, to compute, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, its income from installment sales on the basis of the taxable period for which such income is accrued, in lieu of the basis provided by section 44 (a). Except as hereinafter provided, such election shall be irrevocable when once made and shall apply also to all subsequent taxable years, and the income from installment sales for each taxable year before the first year with respect to which the election is made but beginning after December 31, 1939, shall be adjusted for the purposes of this subchapter to conform to such election. In making such adjustments, no amount shall be included in computing excess profits net income for any excess profits tax taxable year on account of installment sales made in taxable years beginning before January 1, 1940. If the taxpayer establishes, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, that in a taxable year subsequent to the year with respect to which an election has been made under the preceding provisions of this subsection it would not be eligible to elect such accrual method, the tax-

payer may in accordance with such regulations elect in its return for such year to abandon such accrual method. Such election shall be irrevocable when once made and shall preclude any further elections under this subsection. For the taxable year for which the latter election is made and subsequent taxable years, income shall be computed in accordance with section 44 (c).

(b) *Election on Long-Term Contracts.*—

* * *

(c) *Adjustment on Account of Change.*—If an adjustment specified in subsection (a) or subsection (b), as the case may be, is, with respect to any taxable year, prevented, on the date of the election by the taxpayer under subsection (a) or subsection (b), as the case may be, or within two years from such date, by any provision or rule of law (other than this section and other than section 3761, relating to compromises), such adjustment shall nevertheless be made if in respect of the taxable year for which adjustment is sought a notice of deficiency is mailed or a claim for refund is filed, as the case may be, within two years after the date such election is made. * * *

(26 U.S.C. 1940 ed., Sec. 736.)

Treasury Regulations 109, promulgated under the Internal Revenue Code:

SEC. 30.736(a)-2 [as added by T.D. 5257, 1943 Cum. Bull. 856, 859]. *Election to Compute Excess Profits Income on Straight Ac-*

crual Basis.—If a taxpayer computing income from installment sales under the method provided by section 44 (a) establishes eligibility for relief under section 736 (a) and section 30.736(a)-1 with respect to a taxable year beginning after December 31, 1941, it may elect in its excess profits tax return for such year to compute income attributable to installment sales on the basis of the taxable period for which such income is accrued, in lieu of the basis provided by section 44 (a), pursuant to which income for any taxable year is determined to be that proportion of the installment payments actually received during the year which the gross profit realized or to be realized when payment is completed, bears to the total contract price.

* * * * *

If the taxpayer elects in a taxable year beginning after December 31, 1941, and under the provisions of section 736 (a) and this section to compute its income from installment sales on the straight accrual basis, such election shall be irrevocable when once made and shall apply also to all subsequent taxable years and the income from installment sales for each taxable year before the first year with respect to which the election is made, but beginning after December 31, 1939, shall be adjusted for the purposes of the excess profits tax computation to conform to such election. Since no change in the computation of income from the installment basis to the straight accrual basis can be made for any year beginning prior to

January 1, 1940, as a result of such election, no recomputation can be made for any year in the base period. If the taxpayer uses the excess profits credit based on income pursuant to section 713 or section 742, the average base period net income shall be the actual average base period net income with income from installment sales computed under the method pursuant to which such income was reported for the purposes of the income tax under Chapter 1 for the taxable years in such period. If the taxpayer uses the excess profits credit based on invested capital pursuant to section 714, the determination of accumulated earnings and profits shall be made without regard to any adjustment resulting from election made under section 736 (a) and this section, except as such election is reflected in the amount of income tax or excess profits tax payable for taxable years beginning after December 31, 1939. The election made pursuant to section 736 (a) and this section to compute income on the straight accrual basis in lieu of the basis provided in section 44 (a) shall apply only with respect to excess profits net income for purposes of the excess profits tax imposed by Subchapter E of Chapter 2. For purposes of the income tax under Chapter 1, or the surtax on personal holding companies or the declared value excess profits tax under Chapter 2, income shall be computed upon the basis provided in section 44 (a).

* * * * *

☆ U. S. GOVERNMENT PRINTING OFFICE: 1950 891320 757